SUPREME COURT, U. S.

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IN THE

Supreme Court of the United States

OCTOBER TERM 1968

No. 897

FRANCIS G. COATES,
Petitioner,

v.

SECURITIES AND EXCHANGE COMMISSION,
Respondent.

PETITIONER'S REPLY BRIEF

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I

In its Brief in Opposition to our Petition, the Commission erroneously suggests (pp. 2, 14) that the only question presented by our Petition is whether, *assuming* that Section 10(b) and the relevant subdivisions of Rule 10b-5* prohibit a corporate insider from trading on the basis of important information not available to the public, such prohibition continues after the information has been released at a press conference. The Commission's brief thus ignores the fact that our Petition directly challenges the validity of the Commission's basic assumption.

Although the Commission contends that Section 10(b) and Rule 10b-5 prohibit insiders from purchasing their corporation's securities on an exchange without disclosing material information to the sellers, it makes no effort to

*Only subdivisions 1 and 3 are relevant herein. *See* Petition, p. 11.

demonstrate by analysis how such conduct comes within the Rule's prohibition against fraud or deceit. Instead, it merely asserts that Rule 10b-5 contains such a prohibition (Brief in Opposition, pp. 11, 14, 21) and argues that such a prohibition is appropriate and consistent with statutory objectives (Brief in Opposition, pp. 12, 14-17). However, the question presented herein is not whether such a prohibition, affecting directorial conduct, may be desirable for the protection of the investing public. The question is whether such prohibition is contained in the Rule 10b-5 proscription against fraud or deceit.

Petitioner does not contend, as the Commission suggests (Brief in Opposition, pp. 19-20), that an insider is insulated from liability under Section 10(b) and Rule 10b-5 merely because his purchase or sale is executed on a securities exchange. Regardless of whether the transaction is executed on a securities exchange or conducted face-to-face the question is whether the circumstances of the transaction impose a duty of disclosure on the corporate insider so that a failure to disclose may constitute fraud or deceit. It is fundamental that mere nondisclosure is not fraud unless there is a duty to disclose. Contrary to the Commission's statements (Brief in Opposition, pp. 14, 21), prior to this action no Court has held an insider to have violated Section 10(b) or subdivisions (1) or (3) of Rule 10b-5 for failing to disclose material information to those from whom he purchased his corporation's securities unless there were special facts which created a duty of disclosure.*

*The cases cited by the Commission (Brief in Opposition, p. 21, fn. 22) involved alleged schemes by insiders to induce minority shareholders to sell their stock by (1) reducing the dividend in order to depress the market value of the stock and concealing the identity of the buyer, (2) making untrue statements and failing to state facts necessary in order to make statements made not misleading or (3) concealing facts, including the identity of the buyer, in negotiated transactions under circumstances which entitled the seller to expect a statement of all material facts.

This Court's opinion in *Strong* v. *Repide*, 213 U. S. 419 (1909), makes clear that the materiality of information is not in itself a "special fact" creating such a duty and petitioner's acts did not involve any of the facts and relationships which heretofore have been or could be held to create a duty to disclose. Therefore, petitioner was not under a duty to disclose inside information at the time he placed his order, sellers did not expect any disclosures from him and his failure to make disclosures could not constitute fraud or deceit.

II

The Commission argues that a director's purchase of stock on the basis of inside information constitutes fraud or deceit even if he honestly believed the information to be available to the public (Brief in Opposition, pp. 17-19). In so arguing, the Commission relies on this Court's opinion in *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U. S. 180 (1963). However, in that action this Court, although holding that "intent to defraud" did not have to be established because of the nature of the proceeding before it,* did not hold that negligence may be equated with fraud even in that context and expressly found the entirely separate element of "scienter" to be present. Moreover, it is significant to note that *Capital Gains* came before this Court on a denial of the Commission's application for a preliminary injunction to prevent the adviser from defrauding his

*An injunctive action against a registered investment adviser under the Investment Advisers Act which reflects:

> ". . . a congressional recognition 'of the delicate fiduciary nature of an investment advisory relationship,' as well as a congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser —consciously or unconsciously—to render advice which was not disinterested." (375 U. S. at 191, 192).

clients. By contrast, in this proceeding, the Commission is not attempting to protect the investing public from future conduct by petitioner, rather, it is seeking to punish him for allegedly committing fraud in 1964.* Where, as here, the Commission is seeking to punish an alleged wrongdoer its burden is and should be greater than if it were merely seeking to protect the public from future frauds through the "mild prophylactic" of disclosure.

Thus, even if one were to assume the existence of a duty to disclose, petitioner's honest belief that the news had been disseminated would preclude a finding of fraud or deceit. Petitioner does not argue, as the Commission erroneously suggests, that his purchases were not fraudulent because he made a mistake of law, *i.e.*, that he was not "aware of the duty" of disclosure (Brief in Opposition, pp. 11-12). Petitioner's position is that he honestly believed that the news had been disseminated, a position sustained by the court below (App. A, 3619, 3621).** Petitioner, therefore, cannot be held to have committed fraud or deceit.

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*The Commission stated to the District Court in its opening statement that:

> "The Commission's objective in bringing these proceedings before the Court are to drag to light and pillory the misconduct of the individual defendants in these proceedings." (Joint Appendix in the Court of Appeals, p. 283a).

**Petitioner did not place his order "at the very moment that dramatic news . . . [was] handed out to the news media" as the Commission suggests (Brief in Opposition, p. 14) but only after he believed that the news would be on the broad tape. The reasonableness of petitioner's belief that the news would be on the broad tape within minutes after reporters left the press conference is confirmed by the Dow Jones reporter (R. 2453-54) and by the Commission which concedes that:

> "The first section would normally have appeared on the broad tape within two or three minutes after the reporter had dictated it." (Brief in Opposition, p. 9, fn. 3).

III

The Commission makes no effort to demonstrate, and cannot demonstrate, that Section 10(b) and Rule 10b-5 give notice that they apply to conduct untainted by fraud and prohibit purchases by a director even after corporate information has been publicly announced. Indeed, the Commission concedes the vagueness of Rule 10b-5 asserting that it is stated "in rather broad terms which absorb their meaning from the particular business context in which the deceptive practices occur" (Brief in Opposition, p. 24). It is clear, therefore, that Section 10(b) and Rule 10b-5 as now construed by the Commisison and the Court below lack the ascertainable standard of conduct required by the United States Constitution.

IV

The questions presented herein are of great importance to all corporate officers and directors and to the investing public and, as this Court recently noted, arise "in an area where glib generalizations and unthinking abstractions are major occupational hazards." *SEC* v. *National Securities, Inc.*, 89 S. Ct. 564, 571 (1969).

Although the Commission concedes the "significance of the case out of which this petition for a writ of certiorari arises" it seeks to avoid review of the questions presented herein on the ground that the questions are narrow ones of limited interest (Brief in Opposition, pp. 14, 17, 25). That assertion is without basis in fact.* Petitioner is the only remaining defendant in the *Texas Gulf* case who was

*The New York Stock Exchange in a policy statement adopted long after petitioner's purchases, advises that corporate officials should wait until after the release of important developments has appeared in the press before making a purchase or sale. However, that is merely a suggested rule of thumb and not a "requirement"

charged with purchasing Texas Gulf stock after the conclusion of the company's April 16 press conference and only his petition can present all of the fundamental questions raised herein. In addition, a related petition, *i.e., Kline* v. *SEC* (No. 937), is also pending before this Court. The two petitions present virtually the full spectrum of questions presented by the Commission's charges against the individual defendants in *SEC v. Texas Gulf Sulphur.*

The Commission is incorrect when it asserts that this petition does not "raise either the question whether some further dissemination than appearance on the Dow Jones broad tape is necessary, or whether a waiting period after dissemination is necessary in order to give the public an opportunity to evaluate the news" (Brief in Opposition, p. 17). The Court of Appeals held that petitioner's violations encompass not only his purchases but purchases by his son-in-law and customers of his son-in-law (App. A, 3622 fn. 23). Many of those purchases were made hours after the news had appeared on the broad tape (Joint Appendix in the Court of Appeals, p. 238a).

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binding on insiders of corporations listed on that Exchange as the Commission argues (Brief in Opposition, p. 17), New York Stock Exchange, *Company Manual,* A-24 to A-27 (July 18, 1968). The New York Stock Exchange states that "the final decision of each officer and director with respect to securities transactions must be his own" (A-26, A-27). The new New York Stock Exchange guideline in no way diminishes the vast importance of the issues presented herein. Moreover, as of January 31, 1969, 1,273 corporations were listed on the New York Stock Exchange compared with the more than 950 corporations whose shares are listed on the American Stock Exchange and more than 18,000 corporations whose shares are traded in the over-the-counter market. See News Release, New York Stock Exchange News Bureau, Feb. 5, 1969; American Stock Exchange, *Stocks on the Amex,* Mid-1968 Ed.; The National Quotation Bureau, *The National Monthly Stock Summary,* Jan. 1, 1969.

It is significant that the statement of the New York Stock Exchange promulgated long after petitioner's purchases is the only guideline cited by the Commission which suggests a waiting period after corporate announcements.

This petition squarely raises basic questions as to the scope, meaning and constitutionality of "one of the most important and elusive" and likely "the most litigated" provision in the federal securities laws, *SEC* v. *National Securities Inc., supra,* 89 S. Ct. at 571, 574. Those questions have not been and should be decided by this Court.

CONCLUSION

For the foregoing reasons, and the reasons set forth in the petition, this petition for a writ of certiorari should be granted.

March 21, 1969

Respectfully submitted,

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